Supreme Court, U.S.
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No.

IN THE
SUPREME COURT OF THE UNITED STATES
OCTOBER TERM 1998

Peoples Bank and Trust Company
of Hazard,
Petitioner,

v.

Wilson David Penick, doing business as
W. Penick Electrical Construction, Inc.,
Respondent.

ON PETITION FOR WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

PETITION FOR WRIT OF CERTIORARI

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QUESTION PRESENTED

Does the sole officer and director of an insolvent corporation occupy a position of trust relative to the corporation's creditors in order to satisfy the "fiduciary capacity" requirement of 11 U.S.C. § 523(a)(4)?

In nondischargeability actions of this type in bankruptcy, in determining whether the "fiduciary capacity" requirement of § 523(a)(4) is met, courts have uniformly required that a "trust relationship" exist between the bankrupt debtor seeking discharge and the party seeking avoidance. The issue which arises here is whether trusts and fiduciary relationships which exist at *common law*, such as lawyer-client and director-shareholder relationships, are sufficient to meet the fiduciary capacity requirement of the statute. The United States Court of Appeals for the Sixth Circuit split with other circuits and departed from the prior holdings of this Court in answering the question in the negative.

PARTIES TO THE PROCEEDINGS

Respondent, Wilson David Penick, doing business as W. Penick Electrical Construction Co., Inc., an individual, was the named appellant in the proceeding before the Sixth Circuit.[1]

Petitioner, Peoples Bank and Trust Company of Hazard was the named appellee in the proceeding before the Sixth Circuit. Peoples Bank is a Kentucky banking corporation which is located in Hazard, Kentucky.

1

W. Penick Electrical Construction Co., Inc., was not incorporated. Notwithstanding this, it filed state and federal tax returns, had an tax identification number, maintained a bank account and owned property. Mr. Penick has suggested that he and the Company are the same and § 523(a)(4) should not apply. Despite this, Mr. Penick never filed a certificate of assumed name. Although one judge at the Sixth Circuit raised the question during oral argument, that Court, the District Court and the bankruptcy court were unconcerned about this issue. Should it be a factor in this Court's mind in accepting review, then it is respectfully urged that review of the legal issue be granted concerning the interpretation of the statute and, if necessary, the case be remanded for further proceedings as to the *de facto* corporate status of W. Penick Electrical Construction Co., Inc.

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OPINIONS BELOW

The opinion of the United States Court of Appeals for the Sixth Circuit reversing the United States District Court for the Eastern District of Kentucky is not reported, but is attached. A-3 - A-13.[2] There is no official citation. The opinion and order of the District Court reversing the United States Bankruptcy Court for the Eastern District of Kentucky is unreported and also attached. A-14 - A-21. The opinion of the Bankruptcy Court is unreported and attached. A-22 - A-35.

JURISDICTION

The opinion and order of the Sixth Circuit was entered on May 28, 1998. A petition for rehearing was denied by order entered on July 16, 1998. A-1 - A-2. This petition for writ of certiorari is being filed within the prescribed period of ninety days after July 16, 1998. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

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2 All references beginning with "A- " followed by a number are to the numbered pages of Appendix A.

STATUTORY PROVISION INVOLVED

Section 523(a)(4) of Title 11 of the United States Code provides in relevant part:

> A discharge under Sections 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt -- . . . (4) for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny . . . . [Emphasis added].

STATEMENT OF THE CASE

Overview

In 1989, W. Penick Electrical Construction Co., Inc. (sometimes the "Company"), became insolvent. Yet, beginning in 1990 through 1994, as the sole officer and director of the Company, the debtor, Wilson David Penick (sometimes "Mr. Penick"), withdrew $520,265 from the Company for his personal use. Mr. Penick's withdrawals were treated as shareholder loans on the Company's corporate books and income tax returns, but were not repaid. Peoples Bank is the largest creditor of the Company, being owed $317,820.

From 1989 forward, as a matter of law, Mr. Penick owed a fiduciary duty to Peoples Bank, as the Company's largest creditor, to maintain and preserve the assets of the Company for the benefit of the Company's creditors. By withdrawing $520,265 of the Company's assets for his personal use, sums which should otherwise be available to pay the Company's creditors, including Peoples Bank, Mr. Penick committed a defalcation while acting in a fiduciary capacity within the meaning of 11 U.S.C. § 523(a)(4).

The Bankruptcy Court dismissed Peoples Bank's complaint, rejecting the notion that a common law fiduciary relationship would satisfy the fiduciary capacity requirement of § 523(a)(4). A-31 - A-33. The District Court disagreed and held that once a company becomes insolvent, officers and directors hold company assets in trust for the benefit of creditors. A-17 - A-20. The Sixth Circuit reversed and held that this common law relationship, without more, was insufficient. A-11 - A-12.

Bankruptcy Court

Mr. Penick's bankruptcy petition was filed on March 20, 1995. On November 17, 1995, Peoples Bank commenced the adversary proceeding by filing a complaint in the Bankruptcy Court to prohibit the discharge of obligations owed by Mr. Penick for defalcation while acting in a fiduciary capacity under 11 U.S.C. § 523(a)(4). On June 7, 1996, Peoples Bank filed a motion for summary judgment. On June 24, 1996, Mr. Penick filed a cross-motion for summary judgment. Both motions were fully briefed. On July 3, 1996, Peoples Bank and Mr. Penick filed joint stipulations of fact and jointly submitted the case to the Bankruptcy Court without a trial. The stipulations included a statement that the Company was insolvent as of 1989 and that Mr. Penick had withdrawn $520,265 from the Company for personal use.

On July 31, 1996, the Bankruptcy Court entered a final order dismissing Peoples Bank's complaint along with a memorandum opinion sustaining Mr. Penick's motion for summary judgment. A-22 - A-35. The Bankruptcy Court found that Peoples Bank failed to demonstrate the existence of a technical or express trust and therefore did not satisfy the "fiduciary capacity" requirement of § 523(a)(4). A-31 - A-33.

District Court

On August 9, 1996, Peoples Bank filed a notice of appeal to the District Court. Both Peoples Bank and Mr. Penick again fully briefed the issue and submitted the appeal for consideration by the District Court. On March 31, 1997, the District Court entered an opinion and order reversing the Bankruptcy Court finding that the Bankruptcy Court had erroneously interpreted § 523(a)(4). A-14 - A-21. The District Court relied on the seminal case in the Sixth Circuit, styled *Carlisle Cashway, Inc. v. Johnson (In re Johnson)*, 691 F.2d 249 (6th Cir. 1982) and noted that who is a fiduciary is a question of federal law, but state law was an important factor. A-17. The District Court correctly observed that most courts today recognize that the technical or express trust requirement is not limited to formal trust agreements, but also includes relationships in which a statute or the common law imposes trust-type relationships, such as a lawyer's fiduciary duty to this client or a director's duty to his corporation's shareholders. A-18.

The District Court held that under Kentucky's common law, once a corporation becomes insolvent, the fiduciary duty a director otherwise owes to a corporation's shareholders shifts and extends to the corporation's creditors, citing *Aero Drapery of Kentucky, Inc. v. Engdahl*, 507 S.W.2d 166, 168 (Ky. 1974) and *Rider v. The John G. Delker & Sons Co.*, 140 S.W. 1011, 1013 (Ky. 1911)("[V]iolation of this well understood principle is a breach of trust. . . ."). A-18. The District Court held that Mr. Penick was indeed a fiduciary within the meaning of § 523(a)(4) and that the obligations were therefore not dischargeable. A-20.

Sixth Circuit

On April 7, 1997, Mr. Penick filed a notice of appeal to the Sixth Circuit. The appeal was fully briefed. On May 28, 1998, the Sixth Circuit entered an opinion reversing the District Court. A-3 - A-13. In so doing, the Sixth Circuit wrote an opinion as if it were deliberately trying to set this case up for review by this Court. It acknowledged that "courts have developed slightly different interpretations 'of the fiduciary relationship necessary to trigger the defalcation provision of § 523(a)(4).'" A -7. In footnote one of its opinion, the Sixth Circuit acknowledged the contrary holding of the Seventh Circuit in *In re Marchiando, 13 F.3d 111, (7th Cir. 1994), cert. denied sub nom., Illinois Dep't of Lottery v. Marchiando*, _____ U.S. _____, 114 S. Ct. 2675, 129 L.E.2d 810 (1994). The Sixth Circuit rejected *In re Marchiando*, and adopted a narrower interpretation of § 523(a)(4). A-10. Although it only acknowledged a split with the Seventh Circuit, it split with the Second Circuit as well.

The Sixth Circuit tried to narrow the exception to discharge under § 523(a)(4) by imposing an additional requirement of a pre-existing "express or technical trust relationship arising from the placement of a specific res in the hands of the debtor." A-12. The Sixth Circuit did not say what it meant by "express or technical trust." It cited two prior holdings where statutory trusts were involved[3] implicitly indicating that it was looking for the existence of a statutory trust. A-8 - A-9. However, Peoples Bank contended that a common law trust existed, instead of a

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3 *Capitol Indemnity Corp. v. Interstate Agency, Inc. (In re Interstate Agency, Inc.)*, 760 F.2d 121, 124 (6th Cir. 1985); *Carlisle Cashway, Inc. v. Johnson (In re Johnson)*, 691 F.2d 249 (6th Cir. 1982).

statutory trust. Without completing its analysis of what was and was not included within the category of express or technical trusts, the Sixth Circuit tried to fit this case into its prior holding in *R. E. America, Inc. v. Garver (In re Garver)*, 116 F.3d 176, 178 (6th Cir. 1997) by opining that there was no trust res in the hands of Mr. Penick. A-9 - A-10.

In *Garver*, the Sixth Circuit held that fiduciary obligations appurtenant to an attorney and client relationship, without more, would not meet the trust requirement. A-9 - A-10. There also had to be a trust res and that requirement was missing in *Garver*. It is for that very reason, *Garver* is inapplicable here.

R.E. America, Inc. ("REA") had deposited funds with Garver that Garver then conveyed to a holding company in which he and REA had an interest. However, Garver failed to invest a like amount in the company in accordance with his agreement with his client, REA. The company failed and the investment was lost. REA obtained a judgment against Garver for legal malpractice. Garver sought relief in bankruptcy, but REA opposed the discharge of its judgment.

The Sixth Circuit held there could be no defalcation because Garver did not possess the trust res. Although REA had delivered funds to him, Garver had properly transferred those funds to the holding company and could therefore account for them. Garver's liability in bankruptcy resulted from his legal malpractice, not from a misappropriation of funds that he, as an attorney, was holding for his client. The Court logically held that without a res, there was no trust and without a trust, there was no defalcation.

In contrast, Mr. Penick possessed a trust res. The Company still had assets in 1989 when it became insolvent, and Mr. Penick, as its sole officer and director, thereafter held those assets in trust for the benefit of the Company's creditors. Nevertheless, he caused the

Company to distribute $520,265 to himself for personal use after it became insolvent. In doing so, he violated his fiduciary duty to the Company's creditors and dissipated the assets of the trust.

The Sixth Circuit failed to comprehend that from the time of the Company's insolvency, its assets constituted the trust res. The Sixth Circuit's misapprehension of *Garver* was brought to its attention by Peoples Bank's petition for rehearing. Although the Sixth Circuit requested a response from Mr. Penick, it was unwilling to address its own error and denied the rehearing.

REASONS FOR GRANTING THE WRIT

Three reasons exist for granting the petition. First, the Sixth Circuit ignored precedent from this Court. Second, and as a result, there is a distinct split among the circuit courts of appeal concerning the interpretation and application of § 523(a)(4). Third, the Sixth Circuit's holding presents a double standard for officer and director conduct.

United States Supreme Court Precedent

Not since *Davis v. Aetna Acceptance Company*, 293 U.S. 328, 55 S. Ct. 151, 79 L. Ed. 393 (1934), has this Court addressed this issue. In *Davis*, the Court's opinion concerned the resulting or constructive nature of equitable type trusts which arise as a result of a wrongful act. This Court opined that those equitable types of trusts were not the types of trusts to which the statute would apply. *Davis*, 293 U.S. at 333. It therefore limited the application of the earlier version of § 523(a)(4) in a manner consistent with the statute.

Justice Cardozo, writing for the Court, in *Davis*, stated:

> It is not enough that, by the very act of wrongdoing out of which the contested debt arose, the bankrupt has become chargeable as a trustee *ex maleficio*. He must have been a trustee before the wrong and without reference thereto. In the words of Blatchford, J.: "The language would seem to apply only to a debt created by a person who was already a fiduciary when the debt was entered." *Upshur v. Brisco, supra*, at page 378 of 138 U.S., 11 S. Ct. 313, 318.

Davis, 293 U.S. at 333.

This Court recognized that fiduciary duties attach to officers and directors when a corporation is insolvent. In *Wabash, St. L. & P. Ry. Co. v. Ham*, 114 U.S. 587, 594, 5 S. Ct. 1081, 1084, 29 L. Ed. 235 (1885), the trust principle was enunciated as follows:

> The property of a corporation is doubtless a trust fund for the payment of its debts, in the sense that when the corporation is lawfully dissolved and all its business wound up, or when it is insolvent, all its creditors are entitled in equity to have their debts paid out of the corporate property before any distribution thereof among stockholders. It is also true, in the case of a corporation, as in that of a natural person, that any conveyance of property of the debtor, without authority of law, and in fraud of existing creditors is void as against them. (citations omitted).

From these two holdings, two principles are established: (i) property of an insolvent corporation constitutes a trust fund for the benefit of creditors and (ii) the fiduciary duties of officers and directors with respect to that trust fund exist upon that insolvency. The Sixth Circuit's failure to hold Mr. Penick accountable for the distributions he made to himself after the Company was insolvent contravenes these principles and the plain language of § 523(a)(4).

Holding of the Seventh Circuit

An opinion which could serve as a benchmark for these type cases was rendered by the Seventh Circuit in *In re Marchiando*, 13 F.3d 111 (7th Cir. 1994), *cert. denied sub nom., Illinois Dep't of Lottery v. Marchiando*, ____ U.S. ____, 114 S. Ct. 2675, 129 L.E.2d 810 (1994). Like *Davis*, the Seventh Circuit distinguished between trusts *ex maleficio* and those which pre-exist the act. That Court reconciled the principles of common law fiduciary duties:

> The key to knitting the cases into a harmonious whole is the distinction stressed in *Davis* and other cases between a trust or other fiduciary relation that has an existence independent of the debtor's wrong and a trust or other fiduciary relation that has no existence before the wrong is committed. A lawyer's fiduciary duty to his client, or a director's duty to his corporation's shareholders, pre-exists any breach of that duty, while in the case of a constructive or resulting trust there is no fiduciary duty until a wrong is committed.

Holding of the Second Circuit

Peoples Bank has never argued that the trust at issue here is the result of a wrong. Throughout, Peoples Bank has insisted that due to the insolvency of the Company in 1989, Mr. Penick was a trustee *before the wrong and without reference to it*. So far, that is the only limitation this Court and other court of appeals have placed on actions under § 523(a)(4) with respect to the common law trust requirement.

That assets of an insolvent corporation are charged with a trust for the benefit of the company's creditors has long governed debtor/creditor relations. Relying on the holding in *Wabash, supra*, Judge Learned Hand eloquently restated the principle in *Wood v. National City Bank*, 24 F.2d 661, 663 (2d Cir. 1928), as follows:

> However, there is quite another theory, and quite another liability, if the payments not only impair the capital, but are taken out of assets already too small to pay the existing debts. The situation then strictly is not peculiar to corporation law, but merely an instance of payment from an insolvent estate. Since, as we have said, a stockholder is a donee, he receives such payments charged with whatever trust they were subject to in the hands of the corporation. In that situation it can indeed be said with some trust that the corporate assets have become a 'trust fund'. *Wabash, etc. Ry. v. Ham*, 114 U.S. 587, 594, 5 S. Ct. 1081, 29 L. Ed. 235. Hence it has never been doubted, so far as we can find, at least in any federal court, that if the dividends are paid in fraud of creditors the stockholder is so liable.

Holding by the Sixth Circuit

Despite the prior holdings of this Court and those of others circuits, the Sixth Circuit imposed a narrow interpretation of the statute, by excluding common law trust obligations. A-11. It held that common law trust obligations associated with insolvent corporations, as recognized by federal and Kentucky courts, would not suffice. A-11. Its holding presents an artificially narrow construction of § 523(a)(4) which can not be discerned from the statute itself and which is squarely at odds with the precedent from this Court and that of other circuits.

Other Courts

Like the District Court, courts today refrain from limiting the meaning of express and technical trusts. In many cases, courts have expressly observed that statutory and common law trusts are sufficient. In *Kapila v. Talmo (In re Talmo)*, 175 B.R. 775, 777 (Bankr. Fl. 1994), the bankruptcy court held that: "The 'technical or express trust requirement' is not limited to formal contractual trust agreements, however, but can include relationships in which trust type obligations are imposed pursuant to statute, or potentially by common law." *See also In re Jones*, 158 B.R. 731, 733 (Bankr. Tn. 1993) and *In re Kelly*, 84 B.R. 225, 229 (Bankr. Fl. 1988).

An excellent statement of the common law trust principle is found in *Energy Products Engineering, Inc. v. Reuscher (In re Reuscher)*, 169 B.R. 398, 403 (S.D. Ill. 1994), where the court held:

> Up to the point of insolvency, corporate officers or directors owe no duty to the corporation's creditors. Therefore, the officers and directors are not liable for the corporation's debts to such creditors.

> But when the corporation becomes insolvent or is dissolved, the officers and directors then assume fiduciary obligations to preserve and protect the corporation's assets for the creditors. If they carry out those fiduciary duties by properly preserving the corporation's assets and distributing them to creditors based upon the latter's appropriate pro rata share or priority, then the officers or directors will not incur a debt that is subject to nondischargeability under § 523(a)(4).
>
> When viewed in this context, it is clear that the officer/director's wrongful conduct does not create the fiduciary duty. Rather, the duty arose upon the corporation's insolvency or dissolution and the officer/director's subsequent breach of that duty creates an obligation or debt. Accordingly, the Court finds that such a debt is subject to nondischargeability under § 523(a)(4).

Reconciliation with Prior Decisions

The Sixth Circuit did not have to split with other circuits nor depart from the prior holdings of this Court. A correct analysis, like that in *Marchiando, supra*, could be reconciled and made consistent with precedent. To this end, the Sixth Circuit only needed to follow its own previous holding in *Carlisle Cashway, Inc. v. Johnson (In re Johnson)*, 691 F.2d 249 (1992) which provided that:

> The question of who is a fiduciary for purposes of section 17(a)(4) is one of federal law, although state law is important in determining when a trust relationship

> exists. . . . The term 'fiduciary' applies only to express or technical trusts and does not extend to implied trusts, which are imposed on transactions by operation of law as a matter of equity. . . . Moreover, the requisite trust relationship must exist prior to the act creating the debt, and without reference to it. (Citations omitted).

Such a holding here could be easily harmonized with *Davis*, *Wabash*, *Garver* and *Johnson*, *supra*, by simply giving attention to the last sentence of the quoted passage from *Johnson*, above, which begins with "Moreover", or beyond what has been said, "the requisite trust relationship must exist prior to the act creating the debt, and without reference to it." *Johnson* at 252. In other words, beyond what may be said about constructive trusts, resulting trusts, technical trusts or express trusts, the critical inquiry is not one of semantics, but whether the trust relationship existed prior to and without regard to the act creating the debt. That was the basis for this Court's instruction in *Davis*.

Double Standard of Officer and Director Duty

Here, because the Company was insolvent prior to Mr. Penick's misappropriation of its assets, the trust existed prior to the act and without reference to it. Because of his breach of trust, the exception to discharge must apply. Any other result produces a double standard of fiduciary duty and an irreconcilable code of conduct for officers and directors of insolvent companies. Under one rule, officers and directors will occupy the role of trustees and fiduciaries, and creditors may recover from them for conversions made while their company is insolvent. Under the other rule, such as that propounded by the Sixth Circuit, officers and directors will have no obligation to the company's creditors and may disperse

company assets to themselves with impunity so long as the claim is later adjudicated dischargeable in bankruptcy. Such a result is intolerable and certainly not one contemplated by this Court, the other circuits which have addressed the issue or by the United States Congress.

CONCLUSION

The Sixth Circuit has an apparent aversion to nondischargeability in bankruptcy for defalcation. It applied the provisions of § 523(a)(4) in a manner inconsistent with the statutory language of § 523(a)(4) in order to afford that statute an artificially "narrow interpretation." In doing that, the Sixth Circuit applied § 523(a)(4) in a fashion which contravenes uniform application of the law.

Peoples Bank urges this Court to avail itself of this opportunity to make clear that the rules announced in its prior holdings, and those of the circuits which adhered to those precedents, are in fact the controlling law of these United States. In the absence of such a ruling by this Court, uniformity of result which is so important to these cases will be subverted.

Respectfully submitted,

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APPENDIX

APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

FILED
July 16 1998
LEONARD GREEN, Clerk

Case No: 97-5446

WILSON DAVID PENICK, doing business as W. Penick Electrical Construction, Inc. *Debtor*	)	
PEOPLES BANK & TRUST COMPANY OF HAZARD, a Kentucky Banking Corporation *Appellee*	)	
v.	)	**ORDER**
WILSON DAVID PENICK, doing business as W. Penick Electrical Construction, Inc. *Appellant*	)	

BEFORE: KENNEDY, CONTIE and MOORE, Circuit Judges

Upon consideration of the petition for rehearing filed by the appellee,

And further considering the appellant's opposition thereto,

It is ORDERED, that the petition for rehearing be, and it hereby is, DENIED.

ENTERED BY ORDER OF THE COURT

/s/_____
Leonard Green, Clerk

APPENDIX B

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

FILED
May 28 1998
LEONARD GREEN, Clerk

NOT RECOMMENDED FOR FULL-TEXT PUBLICATION

No. 97-5446

In re: WILSON DAVID PENICK, d/b/a W. PENICK ELECTRICAL CONSTRUCTION, INC., *Debtor*,	)	On Appeal from the United States District Court for the Eastern District of Kentucky.
PEOPLES BANK & TRUST COMPANY OF HAZARD, *Plaintiff-Appellee*,	)	
v.	)	
WILSON DAVID PENICK, d/b/a W. PENICK ELECTRICAL CONSTRUCTION, INC., *Defendant-Appellant*,	)	

BEFORE: KENNEDY, CONTIE, and MOORE, Circuit Judges.

PER CURIAM. This case presents the single question of whether the debt Wilson David Penick, d/b/a W. Penick Electrical Construction, Inc., owes to Peoples Bank and Trust Company of Hazard ("Peoples Bank") is excluded from discharge under the United States Bankruptcy Code. Peoples Bank initiated this adversary proceeding in the bankruptcy court, claiming that 11 U.S.C. § 523(a)(4) prohibits the discharge of Penick's indebtedness to Peoples Bank because the debt resulted from Penick's defalcation while acting in a fiduciary capacity. The bankruptcy court held that § 523(a)(4) did not apply to the obligation at issue. On appeal, the District Court reversed. For the following reasons, we reverse the District Court.

I. Facts

From 1980 to 1995, Penick owned and operated an electrical contracting business known as W. Penick Electrical Construction, Inc. ("Penick Electrical"). Although Penick Electrical was never incorporated, Penick also owned Wilson Penick, Inc. ("Penick, Inc."), which the parties stipulated was a validly existing Kentucky corporation. The nature of the relationship between these two entities is not at all clear from the record before us.

In early 1995, Penick Electrical ceased operations after one of its employees was fatally injured in a work-related accident. On March 20, 1995, Penick filed a voluntary petition for bankruptcy protection under Chapter 7 of the Bankruptcy Code. Peoples Bank initiated this adversary

proceeding on November 17, 1995, to determine whether the debt Penick owed to it should be excluded from discharge in bankruptcy under 11 U.S.C. § 523(a)(4). After filing cross motions for summary judgment, the parties filed a joint stipulation of facts and submitted their dispute to the bankruptcy court for resolution.

The undisputed facts consist of the following. Between 1985 and 1993, Peoples Bank made a series of loans to Penick Electrical and Penick, Inc. that were consolidated into a single note, dated June 17, 1993, in the amount of $410,536.69. This note named Wilson Penick, individually, and Wilson Penick, Inc. as the borrowers. No further funds were advanced at that time. From 1990 through 1994, Penick withdrew money from his business through checks drawn on the account of Penick Electrical, and recorded the payments as loans or "shareholder receivables" on that company's financial records and tax returns. Penick apparently invested this money in a struggling hotel that eventually failed. By the 1994 tax year, Penick had yet to repay any of the transfers from Penick Electrical, and they had grown to a total of $520,265.00. Penick was unable to repay the loans from Peoples Bank. Although Peoples Bank recovered some money through state court proceedings, it was still owed $317,820.60 pursuant to the June bank note.

The bankruptcy court issued a memorandum opinion considering Peoples Bank's argument that the debt owed to it by Penick was excepted from discharge under 11 U.S.C. § 523(a)(4) because Penick engaged in defalcation while acting in a fiduciary capacity. Relying on Carlisle Cashway, Inc. v. Johnson (In re Johnson), 691 F.2d 249 (6th Cir. 1982), the bankruptcy court found that Peoples Bank failed to bear its

burden of proving that a trust relationship existed between Penick and its creditors that would make Penick a fiduciary for the purposes of § 523(a)(4). Therefore, it held that the debt owed to Peoples Bank by Penick was not excepted from discharge under that statutory provision.

On appeal, the District Court reversed. It assumed that Penick, Inc. and Penick Electrical were actually a single entity, which was a valid Kentucky corporation. It then held that under Kentucky law "a director of an insolvent corporation owes a fiduciary duty to the corporation's creditors," and concluded that, "Penick was a fiduciary for the purposes of § 523(a)(4)." The District Court then ordered "that the bankruptcy court's Memorandum Opinion is REVERSED and that this matter is REMANDED to the bankruptcy court for further proceedings consistent with this Memorandum Opinion and Order." Penick now appeals the District Court's order.

II. Jurisdiction

Although the District Court phrased its order in the language of an interlocutory decision, the order itself leaves the bankruptcy court with only the tasks of entering judgment in favor of Peoples Bank and formally calculating the amount of the debt, which both parties agree totals $317,820.60. Because the proceedings on remand would be ministerial in nature, we find that the District Court has issued a final decision and order; therefore, we have jurisdiction under 28 U.S.C. § 158(d). See e.g., Breyfogle v. Grange Mut. Cas. Co. (In re Gardner), 810 F.2d 87, 91-92 (6th Cir. 1987).

III. Discussion

When considering an appeal from a district court's initial appellate review of a bankruptcy court's decision, "this court independently reviews the bankruptcy court's findings of fact for clear error and its conclusions of law de novo." R.E America, Inc. v. Garver (In re Garver), 116 F.3d 176, 178 (6th Cir. 1997). This case presents the single issue of whether Penick's indebtedness to Peoples Bank is exempted from discharge in the Chapter 7 proceeding by 11 U.S.C. § 523(a)(4), which provides that "[a] discharge under section 727, 1141,[] 1228(a), 1225(b), or 1328(b) of this title does not discharge an individual debtor from any debt–... for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny." Because Peoples Bank does not allege that the debt results from fraud, embezzlement, or larceny on the part of Penick, our analysis is limited to an application of this section's defalcation provisions to the facts of this case.

The controversy in this case emerges from competing constructions of the statutory phrase "defalcation while acting in a fiduciary capacity." § 523(a)(4). It is well established that the defalcation provision of § 523(a)(4), like the provision of its predecessor, applies to express or technical trusts, but not to constructive trusts that courts may impose as an equitable remedy. Davis v. Aetna Acceptance Co., 293 U.S. 328, 333 (1934). The Davis Court explained that "'[t]he language would seem to apply only to a debt created by a person who was already a fiduciary when the debt was created.'" Id. (quoting Upshur v. Briscoe, 138 U.S. 365, 378 (1891)). As we noted in In re Garver, however, courts have developed slightly different interpretations "of the fiduciary relationship

necessary to trigger the defalcation provision of § 523(a)(4)." 116 F.3d at 178.

We have employed a narrow exception for defalcation while acting in a fiduciary capacity. In a series of three cases, we developed the rule the statute requires not only a pre-existing fiduciary relationship, but also a pre-existing express or technical trust whose res encompasses the property at issue. In Carlisle Cashway, Inc. v. Johnson, 691 F.2d 249 (6th Cir. 1982), we considered whether the requirements of § 17(a)(4) of the Bankruptcy Act of 1898, 11 U.S.C. § 35(a)(4) (1976), the immediate predecessor to § 523(a)(4), were satisfied by statutory trusts created under Michigan's Building Contract Fund Act, M.C.L. §§ 570.152-570.153, when a contractor or subcontractor receives payments in connection with a building project. We noted that "[t]he question of who is a fiduciary for purposes of section 17(a)(4) is one of federal law, although state law is important in determining when a trust relationship exists." 691 F.2d at 251. We then recognized that "[t]he term 'fiduciary' applies only to express or technical trusts and does not extend to implied trusts, which are imposed on transactions by operation of law as a matter of equity." In conclusion, we held that statutory trusts under the Building Contract Fund Act satisfy this requirement for the following reasons: "The trust relationship is unambiguously imposed on a contractor or subcontractor by language of the statute. The trust res is clearly defined as the monies paid by any person into the building contract fund. [And] [t]he trustee is charged with specific affirmative duties . . . ." Id. at 252.

In Capitol Indemnity Corp. v. Interstate Agency, Inc. (In re Interstate Agency, Inc.), 760 F.2d 121, 124 (6th Cir.

1985), we found that under the Michigan Insurance Code of 1956, M.C.L. § 500.1207(1), "premium payments received by an insurance agency have the status of trust funds for the benefit of the insurance principal." We held that the insurance agent's breach of this fiduciary relationship satisfied the requirements of § 17(a)(4) under the old Bankruptcy Act, and rendered the resulting debt non-dischargeable.

In the third of this trio of cases, In re Garver, we drew guidance from In re Interstate Agency, Inc., and explicitly considered "the nature of the fiduciary relationship required under the defalcation provision of § 523(a)(4)." 116 F.3d at 179. In re Garver, involved a debtor, Garver, who had been the attorney of the creditor, R.E. America, Inc. ("REA"). Garver and REA entered a joint venture in which each party was supposed to contribute $600,000 towards the ownership by equal shares of another company. REA turned over the money to Garver, who issued REA an unsecured promissory note executed on behalf of a holding company that Garver controlled. Despite the parties' agreement, Garver contributed only $17,500 of his own money towards the purchase. The joint venture failed, and Garver filed for bankruptcy the following year. In a state court proceeding, a jury found that Garver breached his contract with REA and committed legal malpractice by violating his fiduciary duties to his client, and awarded REA $600,000. In the bankruptcy proceeding, REA sought to have the $600,000 debt excluded from discharge under the defalcation provision of § 523(a)(4). The bankruptcy court ruled the debt non-dischargeable and the district court affirmed. On appeal, we considered whether the fiduciary relationship between attorney and client satisfied the "fiduciary capacity" required by § 523(a)(4).

Although the parties in that case had "stipulated to the existence of a fiduciary relationship satisfying the defalcation provision of § 523(a)(4)," we held nonetheless that "[t]he attorney-client relationship, without more, is insufficient to establish the necessary fiduciary relationship for defalcation under § 523(a)(4). Instead the debtor must hold funds in trust for a third party to satisfy the fiduciary relationship element of the defalcation provision of § 523(a)(4)." 116 F.3d at 179. Under this narrow construction of this provision, "[t]he mere failure to meet an obligation while acting in a fiduciary capacity does not rise to the level of defalcation; an express or technical trust must also be present." Id. We reemphasized this requirement as we concluded: "In sum, under Interstate Agency the defalcation provision of § 523(a)(4) is limited to only those situations involving an express or technical trust relationship arising from placement of a specific res in the hands of the debtor." Id. at 180.[1]

Turning to the instant case, to succeed on its claim, Peoples Bank must show the following by a preponderance of the evidence: first, that there was a fiduciary relationship between it and Penick; second, that this relationship created an express or technical trust that placed a specific res in the hands of Penick; and third, that the Penick then misappropriated or failed to account for those trust funds. See In re Garver, 116 F.3d at 180; In re Interstate Agency, Inc.,

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[1] In contrast to our narrow interpretation, the Seventh Circuit has implied that the fiduciary relationships between lawyers and their clients, or directors and their corporations, would satisfy the "fiduciary capacity" requirement of § 523(a)(4) because the fiduciary obligations pre-exist the debt caused by the breach of that duty. In re Marchiando, 13 F.3d 1111 (7th Cir. 1994).

760 F.2d at 124. In deciding whether Peoples Bank has satisfied these burdens, we "must construe all exceptions to discharge 'strictly,' with the benefit of any doubt going to the debtor." XL/Datacomp, Inc. v. Wilson (In re Omegas Group, Inc.), 16 F.3d 1443, 1452 (6th Cir. 1994) (quoting In re Ward, 857 F.2d 1082, 1083 (6th Cir. 1988)).

Peoples Bank's central argument, which the District Court adopted, was that Kentucky common law creates a trust whenever a corporation is insolvent, and that a director of the corporation then owes a fiduciary duty not to make payments to shareholders to the detriment of the insolvent corporation's creditors. We find that Peoples bank has failed to establish that, under Kentucky Law, the assets of an insolvent corporation form the res of a trust fund that the directors of the insolvent corporation hold in trust for their creditors.

The eases upon which Peoples Bank relies fail to establish more than the principle that an insolvent corporation owes fiduciary duties to its creditors. In Aero Drapery of Kentucky, Inc. v. Engdahl, 507 S.W.2d 166, 168 (Ky. 1974), Kentucky's highest court recognized that a fiduciary relationship exists between a corporation and one of its directors, based on "[t]he position of trust, the freedom of decision, and access to confidential corporate information" enjoyed by the director. In a much earlier ease, Rider v. John G. Delker & Sons Co., 140 S.W. 1011 (Ky. 1911), the same court held that the owner of preferred stock in an insolvent company could not maintain a cause of action to enforce the stock agreement to the detriment of the company's creditors. The court reasoned that when a company is insolvent, "no part of the capital stock can be lawfully returned to the stockholders until all debts are paid or provided for. The

violation of this well-understood principle is a breach of trust, and a creditor affected thereby may pursue the stockholders, and recover as for an unlawful diversion of assets." Id. at 1013 (internal quotation marks omitted). These cases may recognize that a corporation has fiduciary duties to its creditors, but they fall far short of creating the type of clearly defined trusts that existed in In re Johnson, 691 F.2d at 252-53, and in In re Interstate Agency, Inc., 760 F.2d at 124-25. The mere recognition that an insolvent corporation or one of its directors owes a fiduciary obligation to the corporation's creditor's does not create an actual trust fund, as is required by § 523(a)(4).

The District Court and Peoples Bank rely on the decision of the United States District Court for the Southern District of Illinois in Energy Products Engineering, Inc. v. Reuscher (In re Reuscher), 169 B.R. 398, 402 (S.D. Ill. 1994), for the proposition that '"[t]he assets of the [insolvent] corporation must then be regarded as a trust fund for the payment of all its creditors, and the directors occupy a position of trustees . . . . '"(quoting Beach v. Miller, 130 Ill. 162 (1889)). This statement, however, was made in the course of its interpretation of Illinois law and under the broader reading of § 523(a)(4) that the Seventh Circuit has adopted. We employ a narrower reading of § 523(a)(4), and People's Bank has failed to establish that Kentucky law has adopted a similar rule.

As we held in In re Garver, "the defalcation provision of § 523(a)(4) is limited to only those situations involving an express or technical trust relationship arising from placement of a specific res in the hands of a debtor." 116 F.3d. at 180. This situation does not exist in the case before us. Therefore,

we conclude that People's Bank has failed to establish that the debt Penick owed to it satisfied the requirements of the defalcation provision under § 523 (a)(4).[2]

IV. Conclusion

For the foregoing reasons, we reverse the decision of the District Court and reinstate the order of the bankruptcy court dismissing Peoples Bank's complaint.

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[2] Had we not reached this conclusion, we would be inclined to vacate the District Court's decision and remand the case to the bankruptcy court for further proceedings regarding an issue that both parties left unraised: whether Penick's failure to incorporate Penick Electrical undermines Peoples Bank's argument that Penick, as a director of an insolvent corporation, owed a fiduciary duty to the corporation's creditors.

APPENDIX C

UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF KENTUCKY
PIKEVILLE DIVISION

Civil Action No. 96-286

FILED
March 27, 1997
AT LONDON
LESLIE G. WHITMER
CLERK U.S. DISTRICT COURT

PEOPLES BANK & TRUST COMPANY OF HAZARD, a Kentucky Banking Corporation, *Appellant,*	)
v.	) **MEMORANDUM**) **OPINION**) **AND ORDER**
WILSON DAVID PENICK d/b/a W. PENICK ELECTRICAL CONSTRUCTION COMPANY, INC., *Appellee.*	)

This matter is before the court on appeal from the

United States Bankruptcy Court for the Eastern District of Kentucky, Pikeville Division.

The issue on appeal is whether the relationship between a director and a creditor of an insolvent corporation amounts to a fiduciary relationship for purposes of 11 U.S.C. § 523(a)(4).

BACKGROUND

Wilson David Penick ("Penick"), the appellee, owned and operated an electrical construction business known as W. Penick Electrical Construction Company, Inc. (Penick Electrical") from 1980 to 1995. Penick Electrical was not incorporated, but Penick conducted business under the corporate name and believed that the entity was a corporation. Between 1985 and 1994, Peoples Bank & Trust Company of Hazard, Kentucky ("Peoples Bank"), the appellant, made a series of loans to Penick Electrical, Wilson Penick, Inc.,[1] and Penick. The proceeds of these loans were deposited into the general checking account of Penick Electrical. On June 17, 1993, the loans were consolidated into one installment note, executed in the names of Wilson Penick, Inc. and Penick. From 1990 to 1994, Penick borrowed $520,265 from Penick Electrical for his personal use. At all relevant times, both Wilson Penick, Inc. and Penick Electrical[2] were unable to

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[1] Penick states that, because Penick always had conducted business as Penick Electrical, he thought the loans to Wilson Penick, Inc. contained a typographical error.

[2] The court is unclear about the relationship between Wilson Penick, Inc. and Penick Electrical. However, the

satisfy their financial obligations to their creditors. This would have been the case even if Penick had not borrowed $520,265 from Penick Electrical. Neither party disputes that Penick Electrical was insolvent before Penick borrowed the money.

On March 20, 1995, Penick filed a Chapter 7 bankruptcy petition. The current controversy arose in an adversary proceeding filed by Peoples Bank. Peoples Bank claimed that 11 U.S.C. § 523(a)(4) prohibited the discharge of obligations that Peoples Bank claimed Penick owed it because of his defalcation while acting in a fiduciary capacity. The bankruptcy court found that Penick's relationship with Peoples Bank did not arise to the level of a fiduciary relationship and that, accordingly, Penick's obligations were not excepted from discharge.

DISCUSSION

11 U.S.C. § 523(a) provides, "A discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt--...(4) for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny .... " Peoples Bank claims that Penick's outstanding obligations to Peoples Bank are nondischargeable because they are a debt from a defalcation occurring while he acted in a fiduciary capacity. The bankruptcy court found that Penick did not act in a fiduciary

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bankruptcy court's memorandum opinion assumed that they were the same entity and treated that entity as a corporation. For purposes of this appeal, this court will do the same.

capacity for purposes of § 523(a)(4).

The seminal case on this issue in the Sixth Circuit is *Carlisle Cashway, Inc. v. Johnson (In re Johnson),* 691 F.2d 249 (6th Cir. 1982). In *Johnson,* a creditor asserted that a Michigan statute elevated the relationship between the debtor and the creditor to a fiduciary relationship with respect to the debt in question. The court analyzed § 17(a)(4) of the former Bankruptcy Act, the predecessor of § 523(a)(4). The court noted that the question of who is a fiduciary is a question of federal law, although state law is an important factor. *Id.* at 251. The court stated, "The term 'fiduciary' applies only to express or technical trusts and does not extend to implied trusts, which are imposed on transactions by operation of law as a matter of equity." *Id.* The court did not define "express or technical trusts." The court did find that the requisite trust relationship must exist before the act creating the debt occurs and without reference to it. *Id.* at 252. Therefore, trusts that state statutes create upon the occurrence of an act of misappropriation (*ex maleficio*) are not within the scope of § 523(a)(4) because such trusts arise because of the act creating the debt. *Id.*

The bankruptcy court in the present case interpreted Peoples Bank's claim to be that a Kentucky statute created a technical trust. The bankruptcy court found that the statute in question did not create a technical trust. On appeal, Peoples Bank agrees that the statute does not create a technical trust but argues that common law creates a trust relationship. Therefore, this court must address whether common law can create a technical trust.

Various courts have disagreed over the exact meaning

of the requirement of the presence of a technical trust to satisfy § 523(a)(4). *Bennet v. LSP Investment Partnership,* 989 F.2d 779, 784 (5th Cir. 1993). However, most courts today recognize that the technical or express trust requirement is not limited to trusts that arise from formal trust agreements but also includes relationships in which a statute or common law imposes trust-type obligations. *Id.* at 784-85. The important factor that a court must consider when determining whether a fiduciary relationship suffices under § 523(a)(4) is whether the trust or fiduciary relation had an existence independent of the debtor's wrong. *In re Marchiando,* 13 F.3d. 1111, 1115 (7th Cir. 1994). "A lawyer's fiduciary duty to his client, or a director's duty to his corporation's shareholders, pre-exists any breach of that duty, while in the case of a constructive or resulting trust there is not fiduciary duty until a wrong is committed. " *Id.* at 1115-16.

This court must determine whether an insolvent corporation's director has a fiduciary duty for purposes of § 523(a)(4) to a creditor of the insolvent corporation. As the court states above, the question of what constitutes a fiduciary under § 523(a)(4) is a matter of federal law but state law is a factor. Under Kentucky law, a fiduciary relationship exists between a director and the director's corporation. *Aero Drapery of Kentucky, Inc. v. Engdahl,* 507 S.W.2d 166, 168 (Ky. 1974). When a corporation becomes insolvent, the fiduciary responsibility of a director extends to the corporation's creditors. In *Rider v. The John G. Delker & Sons Co.,* 140 S.W.2d 1011, 1013 (Ky. 1911), Kentucky's highest court reflected this concept in the following:

> In Hamlin v. T. St. L. & R. R. Co., 78 Fed., 670, the distinction between a creditor

> and a stockholder...is thus stated: " .... There is a sense in which every shareholder is a creditor of the corporation to the extent of his contribution to the capital stock. In that sense every incorporation includes its capital stock among its liabilities. But that creditor relation is one which exists only between the corporation and its shareholders. It is a liability which is postponed to every other liability, and no part of the capital stock can be lawfully returned to the stockholders until all debts are paid or provided for. The violation of this well understood principle is a breach of trust, and a creditor affected thereby may pursue the stockholders, and recover as for an unlawful diversion of assets ...."

Federal courts have found likewise. For example, in *Wood v. National City Bank,* 24 F.2d 661, 663 (2d Cir. 1928), Judge Learned Hand discussed payments made by an insolvent corporation to its stockholders: "Since, as we have said, a stockholder is a donee, he receives such payments charged with whatever trust they were subject to in the hands of the corporation. In that situation it can indeed be said with some truth that the corporate assets have become a 'trust fund.'" In *Energy Products Engineering, Inc. v. Reuscher (In re Reuscher),* 169 B.R. 398, 402 (S.D. Ill. 1994), the court found,

> [U]nder ordinary circumstances, the officer/director has no fiduciary relationship with the corporation's creditors.
>
> However, this general rule applies only

> to solvent corporations; the situation changes if the corporation becomes insolvent .... "[T]he moment a corporation becomes insolvent its directors occupy a different relation. The assets of the corporation must then be regarded as a trust fund for the payment of all its creditors, and the directors occupy a position of trustees ...."

In the present case, the bankruptcy court found that Penick did not owe Peoples Bank a fiduciary duty. However, a director of an insolvent corporation owes a fiduciary duty to the corporation's creditors. Penick Electrical was insolvent before Penick borrowed money from it. Therefore, the fiduciary relationship arose before and without relation to the wrong. Accordingly, treating Penick Electrical as a corporation as did the bankruptcy court, Penick was a fiduciary for purposes of § 523(a)(4).

CONCLUSION

The court ORDERS that the bankruptcy court's Memorandum Opinion is REVERSED and that this matter is REMANDED to the bankruptcy court for further proceedings consistent with this Memorandum Opinion and Order.

This the 26th day of March, 1997.

/s/_____
Jennifer B. Coffman
UNITED STATES DISTRICT JUDGE
EASTERN DISTRICT OF KENTUCKY

NOTICE IS HEREBY GIVEN OF THE ENTRY OF THIS

Memorandum Opinion and Order - No. 96-286, 3/27/97

ORDER OR JUDGMENT ON 3/28/97

LESLIE G. WHITMER, CLERK

BY: /S/_____
Malinda Bevins

APPENDIX D

UNITED STATES BANKRUPTCY COURT
EASTERN DISTRICT OF KENTUCKY
PIKEVILLE DIVISION

FILED
July 31, 1996
at Lexington
Betty L. Jennette, Clerk
U.S. Bankruptcy Court

IN RE:

WILSON DAVID PENICK d/b/a W. PENICK ELECTRICAL CONSTRUCTION, INC.	
	CASE NO. 95-70169
PEOPLES BANK & TRUST COMPANY OF HAZARD, a Kentucky Banking Corporation Plaintiff,	ADV. NO. 95-7064
vs.	
WILSON DAVID PENICK d/b/a W. PENICK ELECTRICAL CONSTRUCTION, INC. Defendant	

MEMORANDUM OPINION

This matter is before the Court having been submitted on the record. Pursuant to an Order Rescheduling Trial entered herein on April 17, 1996, this matter had been set for trial on July 15, 1996. However, after a hearing on the plaintiff's Motion for Summary Judgment conducted on June 27, 1996, the Court agreed to consider taking the matter under submission upon stipulations. The parties filed their Joint Stipulations on July 3, 1996, and the Court entered an Order setting aside the scheduled trial and taking the matter under submission on July 5, 1996. This Court has jurisdiction of this matter pursuant to 28 U.S.C. §1334(b); it is a core proceeding pursuant to 28 U.S.C. §157(b) (2) (I).

The plaintiff initiated this matter by filing its Complaint on November 17, 1995, alleging that a debt owed to the plaintiff was nondischargeable pursuant to 11 U.S.C. §523(a) (4). The defendant filed his Answer on December 5, 1995. The trial of this matter was originally set for April 18, 1996, but the plaintiff requested a continuance, alleging that the defendant was not cooperating in attempts to complete discovery.

The plaintiff filed a Motion to Compel Responses to Document Requests and Interrogatories and to Shorten Time on April 3, 1996. The defendant filed a Motion to Continue Discovery Deadline and Dispositive Motion Deadline on April 4, 1996, and a Response to the plaintiff's Motion on April 8, 1996. The Order Rescheduling Trial was entered as set out above, and an Order Sustaining Peoples Bank's Motion to Compel was entered on April 26, 1996. The defendant filed an Objection to Proposed Order and Emergency Motion to

Reconsider the Court's Ruling on the same date. An Order Overruling Debtor's Objection was entered on May 6, 1996. The defendant filed a Motion to Compel Discovery and to Extend Deadlines on May 31, 1996.

The plaintiff filed its Motion for Summary Judgment on June 7, 1996. The defendant filed his Response and Cross-Motion for Summary Judgment on June 24, 1996. The plaintiff filed a Response to the Cross-Motion for Summary Judgment on June 27, 1996.

The Joint Stipulation of Facts sets out the following:

"1. The Debtor filed a Chapter 7 bankruptcy petition seeking bankruptcy relief under Chapter 7 of Title 11 of the United States Code in the United States Bankruptcy Court, Eastern District of Kentucky, Pikeville Division, Case Number 95-7-0169, on March 20, 1995.

2. At all relevant times, the Debtor believed that he was, as acted as, the sole officer, director and shareholder of W. Penick Electrical Construction Co., Inc.

3. Articles of Incorporation were never filed with the Kentucky Secretary of State, or in any other state, for W. Penick Electrical Construction Co., Inc.

4. W. Penick Electrical Construction Co., Inc. was engaged in the electrical construction business in eastern Kentucky, and surrounding states.

5. At all relevant times, all of the electrical construction business, in which the Debtor, was involved, was

in the name of W. Penick Electrical Construction Co. Inc. except as provided in paragraphs 15 through 21 hereof.

6. At all relevant times, W. Penick Electrical Construction Co., Inc. prepared and filed state and federal corporate tax returns as a separate corporate entity.

7. W. Penick Electrical Construction Co., Inc. had its own employer identification number being 61-00962526.

8. From 1990 through 1994, the Debtor withdrew money via "corporate" checks from the general checking account of W. Penick Electrical Construction Co., Inc. in irregular amounts for use apart from the electrical construction business.

9. The withdrawals were entered as loans or "shareholder receivables" on the business and financial records of W. Penick Electrical Construction Co., Inc. and are listed as such on the schedules of the corporate tax returns of W. Penick Electrical Construction Co., Inc.

10. According to the tax returns of W. Penick Electrical Construction Co., Inc. the "shareholder receivables" (hereinafter the "Transfers") were listed as follows:

$165,439.89 for tax year 1990;
$331,085.00 for tax year 1991;
$394,429.00 for tax year 1992;
$481,203.00 for tax year 1993; and
$520,265.00 for tax year 1994.

11. There were and are no promissory notes, no repayment schedules, no security interests, no mortgages, no payments of interest, no payments of principal, no maturity date(s), no history of borrowing and repayment, no history of dividends or distributions, no corporate resolutions and no collection actions in connection with the Transfers.

12. On or about February 22, 1996, the Debtor commenced an adversary proceeding in this Court, by filing a complaint for a declaratory judgment to determine the amount and legality of personal income tax liability associated with the Transfers, styled Wilson David Penick, d/b/a Wilson Penick, Inc. a/k/a W. Penick Electrical Construction Co., Inc. vs. United States of America Internal Revenue Service, Commonwealth of Kentucky Revenue Cabinet, Commonwealth of Kentucky Cabinet for Human Resources, City of Hazard and Perry County, Adversary Case No. 96-7006 (the "IRS Complaint").

13. In paragraph five of the IRS Complaint, the Debtor avers that: "The Debtor/Plaintiff owned and operated a business during the approximate calendar years of 1985 to 1995 named Wilson Penick, Inc., a Kentucky corporation, a/k/a W. Penick Electrical Construction Co., Inc. with a business mailing address of P.O. Box 7667, Hazard, Kentucky 41702".

14. At all relevant times, Wilson Penick, Inc. was a validly existing Kentucky corporation.

15. Peoples Bank made its first loan to W. Penick Electrical Construction Co., Inc. on or about September 20, 1985, in the amount of $20,000. Later, on December 3, 1986,

Peoples Bank made another loan to W. Penick Electrical Construction Co., Inc. in the amount of $100,000. As directed by the Debtor, proceeds from these loans were deposited directly into a general checking account in the name of W. Penick Electrical Construction Co., Inc.

16. Beginning on April 28, 1987, through April 15, 1991, Peoples Bank made a series of ten (10) loans to Wilson Penick, Inc. and/or W. Penick Electrical Construction Co., Inc. totaling $333,754.16. As directed by the Debtor, proceeds from these loans were deposited directly into a general checking account in the name of W. Penick Electrical Construction Co., Inc.

17. Each promissory note executed from April 28, 1987 through April 15, 1991 was executed in the name of Wilson Penick, Inc., except for one promissory note dated March 16, 1990, in the amount of $37,500, which was executed in the name of W. Penick Electrical Construction Co., Inc.

18. On January 21, 1992, the outstanding loans in the name of Wilson Penick, Inc. and the March 16, 1990 loan in the name of W. Penick Electrical Construction Co., Inc. were consolidated into one installment note in the amount of $333,754.16, which was executed in the name of Wilson Penick, Inc.

19. On May 20, 1992, a loan was made in the amount of $40,000, for which a promissory noted was executed in the name of Wilson Penick, Inc. As directed by the Debtor, proceeds from this loan were deposited directly into a general checking account in the name of W. Penick

Electrical Construction Co., Inc.

20. On March 18, 1993, another loan was made in the amount of $61,291.20, for which a promissory note was executed in the name of Wilson Penick, Inc. As directed by the Debtor, proceeds from this loan were deposited directly into a general checking account in the name of W. Penick Electrical Construction Co., Inc.

21. On June 17, 1993, all of the outstanding loans in the names of Wilson Penick, Inc. and W. Penick Electrical Construction Co., Inc., including the May 20, 1992 and March 18, 1993 loans were again consolidated into one installment note, in the amount of $410,536.69 (the "June Note"), which was executed in the names of Wilson Penick, Inc. and the Debtor.

22. No additional proceeds were advanced to Wilson Penick, Inc., W. Penick Electrical Construction Co., Inc. or the Debtor, individually, in connection with the consolidation and execution of the June Note.

23. W. Penick Electrical Construction Co., Inc. continued its routine electrical construction business until 1994 when one of its employees was fatally injured in a trucking accident. Thereafter, the United States of America Mine Safety & Health Administration began to more closely scrutinize the safety practices and precautions of W. Penick Electrical Construction Co., Inc. As a result, the Debtor did not consider it feasible, financially or otherwise, to remain in the electrical construction business and caused W. Penick Electrical Construction Co., Inc. to cease its operations in early 1995.

24. During all relevant times, and without taking into account the $520,265.00 in Transfers, Wilson Penick, Inc. and/or W. Penick Electrical Construction Co., Inc. was unable to satisfy its financial obligations to State Electric and Peoples Bank as those respective obligations became due."

The plaintiff's Motion for Summary Judgment contends that it is entitled to judgment as a matter of law that the debt owed to it by the debtor is nondischargeable pursuant to §523(a)(4) because the debtor engaged in defalcation while acting in a fiduciary capacity. The plaintiff has stated that to except the debt from discharge it must demonstrate that the defendant occupied the role of fiduciary in regard to the plaintiff as a creditor of the corporation, that the withdrawals from the corporation were made while the defendant was acting as a fiduciary, and that the plaintiff was harmed as a result of the defendant's actions.

The first issue to be determined is whether the defendant met the definition of a fiduciary. The leading case in the Sixth Circuit on this subject is In re Johnson, 691 F.2d 249 (6th Cir. 1982). There the court was interpreting §17(a)(4) of the Bankruptcy Act, the predecessor of 11 U.S.C. §523(a)(4). The court stated:

> The question of who is a fiduciary for purposes of section 17(a)(4) is one of federal law, although state law is important in determining when a trust relationship exists. .... The term 'fiduciary' applies only to express or technical trusts and does not extend to implied trusts, which are imposed on transactions by operation of law as a matter of

> equity. .... Moreover, the requisite trust relationship must exist prior to the act creating the debt, and without reference to it. (Cites omitted.)

At pages 251-252. This Court must therefore discover the existence of a technical trust in order for the defendant to be considered a fiduciary, looking to state law to determine if a trust relationship exists. As set out in In re Interstate Agency, Inc., 760 F.2d 121 (6th Cir. 1985), state law "determines the nature of the property interest in question." At page 124.

Technical trusts are created by an agreement between the parties to impose a trust relationship, or by a statute that specifically imposes fiduciary obligations on a party. See In re Howell, 178 B.R. 730, 732 (Bkrtcy. W.D.Tenn. 1995). In Johnson the technical trust was created by statute. The court held that:

> [t]he Building Contract Fund Act satisfies the express or technical trust requirements of section 17(a)(4). The trust relationship is unambiguously imposed on a contractor or subcontractor by the language of the statute. The trust res is clearly defined as the monies paid by any person into the building contract fund. The trustee is charged with specific affirmative duties, including paying out trust funds in accordance with the statutorily imposed priority scheme, not using funds for its own purposes so long as trust beneficiaries, laborers, subcontractors and materialmen remain unpaid ....

The plaintiff looks to KRS 271B.6-400(3) to establish the trust relationship between the defendant and his creditors that would make him a fiduciary. It provides:

> (3) No distribution shall be made if, after giving it effect:
>
> (a) The corporation would not be able to pay its debts as they become due in the usual course of business; or
>
> (b) The corporation's total assets would be less than the sum of its total liabilities plus (unless the articles of incorporation permit otherwise) the amount that would be needed, if the corporation were to be dissolved at the time of the distribution, to satisfy the preferential rights upon dissolution of shareholders whose preferential rights are superior to those receiving the distribution.

This provision does not create a trust, notwithstanding any inferences that might be drawn from it concerning a corporate director's "fiduciary" duty to the corporation's shareholders.

The plaintiffs have not demonstrated that the requirements of Johnson do not continue to be good law in the Sixth Circuit. The majority of bankruptcy courts around the Circuit have consistently cited it with approval. Most recently, in In re Sigler, 196 B.R. 762 (Bkrtcy. W.D.Ky. 1996), that court addressed the question of whether the

Kentucky mechanics' and materialmen's lien statute, KRS 376.070, creates a trust so as to allow debts arising in that context to be found to be nondischargeable pursuant to §523(a) (4) .

The Sigler court held that

> Kentucky Revised Statute 376.070 .... directs contractors to make payments to subcontractors and materialmen who have performed services or supplied labor from the proceeds of payments made by the landowner. The statute does not require contractors to 'hold' funds for the benefit of any person, or that the contractor is to act in a 'fiduciary capacity.' It does not utilize the term 'trust' or even the term 'fund.' It simply directs the course of payments received, and nothing more. KRS 376.070. .... This court cannot create an express trust where neither the Legislature nor the parties by contract have designated one to exist. Consequently, finding that no trust exists under the facts of this case, this Court must conclude that the Plaintiffs have failed to meet their burden of proof under §523(a)(4), as that Section of the Bankruptcy Code requires the presence of an express trust in order for a debt to be held dischargeable on the grounds that the Debtor engaged in a defalcation while acting in a fiduciary capacity.

At page 768. This Court must come to the same conclusion,

and find that the plaintiff herein has failed to meet its burden under §523(a)(4) as well. The debt owed to the plaintiff by the defendant is not excepted from discharge pursuant to that statute. An order in conformity with this opinion will be entered separately.

Dated: 7/31/96

By the Court

/s/
Wm. S. Howard
Judge

Copies to:

Debtor
Stanton L. Cave, Esq.
Matthew B. Bunch, Esq.

APPENDIX E

UNITED STATES BANKRUPTCY COURT
EASTERN DISTRICT OF KENTUCKY
PIKEVILLE DIVISION

FILED
July 31, 1996
at Lexington
Betty L. Jennette, Clerk
U.S. Bankruptcy Court

IN RE:

WILSON DAVID PENICK d/b/a W. PENICK ELECTRICAL CONSTRUCTION, INC.	)	
	)	CASE NO. 95-70169
PEOPLES BANK & TRUST COMPANY OF HAZARD, a Kentucky Banking Corporation Plaintiff,	)	ADV. NO. 95-7064
vs.	)	
WILSON DAVID PENICK d/b/a W. PENICK ELECTRICAL CONSTRUCTION, INC. Defendant	)	

ORDER

Consistent with the Memorandum Opinion this day entered, the Court finding no just cause for delay, and being otherwise fully advised,

IT IS HEREBY ORDERED that the plaintiff's Complaint to determine dischargeability of indebtedness is dismissed.

Each party shall be responsible for its own costs.

This is a final order entered this 31st day of July, 1996.

By the Court

/s/_____
Wm. S. Howard
Judge

Copies to:

Debtor
Stanton L. Cave, Esq.
Matthew B. Bunch, Esq.